SHELL WESTERN E & P, INC.

IBLA 87-47 Decided January 23, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming an order of the Royalty Valuation and Standards Division disallowing Federal and state income taxes as elements of transportation costs in calculating royalties on carbon dioxide transported by pipeline. MMS-84-0013-MISC.

Set aside and remanded.

1. Oil and Gas Leases: Royalties: Generally

MMS unfairly discriminates against a CO_2 lessee in denying a deduction for that component of a pipeline tariff relating to Federal and state income taxes solely on the basis that such lessee is an affiliate of the pipeline operator.

APPEARANCES: William G. Riddoch, Esq., Houston, Texas, for appellant; Peter J. Schaumberg, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE FRAZIER

Shell Western E & P, Inc. (SWEPI), has appealed from the August 6, 1986, decision of the Director, Minerals Management Service (MMS), affirming an order of the Chief, Royalty Valuation and Standards Division, MMS, disallowing Federal and state income taxes as elements of transportation costs in calculating royalties on carbon dioxide (CO_2) produced from the McElmo Dome (Leadville) Unit, 1/ located in Dolores and Montezuma Counties,

1/ McElmo Dome is a consolidation of several previous units into a single unit covering a subsurface unitized formation known as the Mississippian Leadville Formation underlying lands in Ts. 36, 37, 38, 39 N., and Rs. 17, 18, 19, and 20 W., New Mexico Principal Meridian. Unitized substances in McElmo Dome are all oil and gas within or produced from the unitized formation. The term "gas" specifically and expressly includes carbon dioxide. Robert D. Lanier, 90 IBLA 293, 93 I.D. 66 (1986) (carbon dioxide produced from McElmo Dome under Federal oil and gas leases).

Colorado, and transported via a pipeline owned by the Cortez Pipeline Company (Cortez) 2/ over 500 miles to the Denver Unit CO_2 project in western Texas.

SWEPI, the successor in interest to Shell Oil Company (Shell), is the operator of the McElmo Dome Unit. On October 25, 1983, representatives of Shell met with representatives of MMS to provide an overview of and a status report on Shell's McElmo Dome/Denver Unit CO_2 Project. At the meeting, MMS requested information concerning the tariff to be charged to Shell by Cortez for transportation of Shell's share of CO_2 produced from McElmo Dome and sold by Shell to the Denver Unit, via the 500-mile pipeline then under construction from southwestern Colorado to the Wasson Field in West Texas where the Denver Unit is located.

By letter dated December 9, 1983, Shell advised MMS of certain information provided by Cortez concerning the tariff to be established for transportation of CO_2 from McElmo Dome to the Denver Unit. In the letter, Shell proposed that the Cortez tariff be allowed as a transportation deduction from the proceeds received by Shell for the sale of CO_2, and that Shell not be required to pay royalty under the Federal leases on that amount.

By letter dated March 29, 1984, MMS advised SWEPI that the Cortez tariff calculation procedure was acceptable to MMS, with the exception that Federal and state income taxes should not be considered in computing transportation costs. MMS explained that "Federal and State income tax should be eliminated before transportation costs are computed. Should they be retained in the computation, royalty must be paid on that portion of the pipeline tariff represented by the Federal and State income taxes" (Letter from MMS to SWEPI dated Mar. 29, 1984, at 2).

By letter dated May 1, 1984, SWEPI appealed the March 29, 1984, decision to the Chief, Royalty Valuation and Standards Division, MMS, arguing as follows:

> There currently is no market for CO_2 produced from the McElmo Dome (Leadville) Unit except for CO_2 purchased by the Denver Unit. The actual cost of transporting CO_2 through the Cortez pipeline from Southwestern Colorado to West Texas is a marketing cost which must be assumed by the royalty owner as well as the working interest owners. These actual costs of transportation, which will in the future include payment of both Federal and State income taxes, constitute the Cortez tariff and are incurred by the Federal lessee who transports CO_2 to the Denver Unit for sale. SWEPI, as a Federal lessee transporting CO_2 to the Denver Unit for sale, is entitled to be reimbursed by the purchaser of CO_2 for the tariff charged for transporting such CO_2, subject to certain limitations as set forth in the Denver Unit CO_2 Sale and

2/ Cortez is a general partnership owned by Shell Cortez Pipeline Company, Mobil Cortez Pipeline Company, and Continental Resources Cortez Pipeline Company.

> Purchase Contract. Since the Sale of CO_2 to the Denver Unit was the first such sale of CO_2 from the McElmo Dome (Leadville) Unit -and is still the only such sale - it was necessary to agree with the Denver Unit working interest owners that they would not bear the full cost of the Cortez pipeline tariff.
>
> Thus, any actual costs of transportation borne by SWEPI which are not reimbursed by the Denver Unit were agreed to through negotiation with the Denver Unit working interest owners. The MMS, however, by its determination not to permit deduction of all the actual transportation charges (the tariff) incurred by SWEPI has arbitrarily and without justification imposed a penalty on SWEPI which was neither negotiated nor anticipated. The full tariff paid by SWEPI should be permitted to be deducted from the price received for CO_2 sales by SWEPI for royalty payment purposes to the MMS.

(Letter dated May 1, 1984, from SWEPI to MMS, at 3-4).

By memorandum dated September 10, 1984, the Chief, Royalty Valuation and Standards Division (RVSD), recommended to the Chief, Division of Appeals, Office of Program Review, that the March 29, 1984, decision be upheld, providing the following rationale for its position:

> The RVSD upholds its previous position with regard to income taxes. In William and Meyers Oil and Gas Law, Vol. 3, § 604.6(b) clearly defines which costs may be considered as a cost of operation; "the current cost of operation has been held to include taxes (other than income taxes) payable by the owner of the working interests." In addition, in Matzen v. Hugeton Production Co., (321 P.2d 576), the Supreme Court of Kansas upheld evidence which established that "from an accounting standpoint, income tax is a sharing of profits, not a cost; that in cost accounting, income tax is never used as a factor in determining cost of operation, cost of sales, nor of any other item." [Emphasis in original.]

By letter to the Chief, Division of Appeals, Office of Payment Review, MMS, dated February 7, 1985, SWEPI registered its disagreement with RSVD's September 10, 1984, memorandum. SWEPI argued that RSVD's reliance upon the definition of "cost of operation" from Williams and Myers was misplaced, stating that "[i]t is a partial quote from Section 604.6(b) * * * taken out of context, which relates to a subject completely different from transportation costs which are allowed as a deduction from the value of royalties" (Letter dated Feb. 7, 1985, from SWEPI to the Chief, Division of Appeals, Office of Payment Review, MMS, at 7). According to SWEPI, "[t]he entire scope of the discussion in this part of the treatise is limited to costs of 'paying production', within the overall construction of a habendum clause in an oil and gas lease for purposes of determining the duration of the lease,"

and that "[t]his section of the treatise has no relevance at all to costs incurred in the transportation of a product, in this case, CO_2, or computation of royalty payments." Id. SWEPI argued as follows:

> The issue under appeal here is not the identification of which costs of production are to be assessed against the non-operator-lessor's usual royalty interest, but is instead the identification of "costs subsequent to production" which are usually borne proportionately by the operating and the non-operating interests. 3 R. Williams, Oil and Gas Law Sections 645.1-.2 (1981). Indeed,
> the quoted definition itself clearly identifies the party whose income taxes are not to be included in the current cost of operations, i.e., "the owner of the working interest," and not a common carrier pipeline.

(Letter dated Sept. 7, 1985, at 8).

In addition, SWEPI maintained that RSVD "misses the mark" by placing its reliance upon Matzen v. Hugoton Production Co., 321 P.2d 576 (Kas. 1958). SWEPI conceded that the "Matzen court properly determined that an operator-lessee and a non-operator-lessor must bear the burden of their own income tax without contribution from the other party" (Sept. 11, 1985, letter (emphasis in original)). SWEPI contended, however, that Matzen "does not stand for the proposition that income taxes of a common carrier pipeline carrier must be borne exclusively out of the operator lessee's interest." Id. at 9. SWEPI reasons as follows:

> What distinguishes the holding of Matzen from the issue in the SWEPI Appeal is the fact that the court disallowed deduction of the lessee's income taxes from the lessor-landowners' royalty. Whereas in the MMS Decision, pipeline owners' income taxes which are included in a pipeline tariff and passed on as a cost to a shipper-lessee as an overall transportation charge are disallowed as deductible costs for the purpose of computing the transportation allowance for royalty purposes. Stated simply, the Matzen case involved income taxes of a lessee, and the instant appeal involves income taxes of a common carrier pipeline. The former is not, and the latter is, a proper component of transportation expense deductible from lessor royalty. [Emphasis in original.]

(Letter dated Feb. 7, 1985, at 10).

By memorandum dated May 6, 1985, from the Chief, RVSD, to the Chief, Division of Appeals, Office of Program Review, the Chief, RVSD, responded to SWEPI's arguments. RVSD explained that its decision to disallow Federal and state income taxes as transportation costs was based upon the Conservation Division Manual (CDM 647.5), which "provides standard guidelines for determining allowable pipeline transportation deductions for royalty purposes for Federal and Indian onshore lands" (Memorandum dated May 6, 1985, at 2). The CDM specifies transportation allowances for (1) producer-owned and operated pipelines (CDM 647.5A); (2) producer-owned (by production payments) pipelines which are not operated by the lessee (CDM 647.5B); and (3) pipelines

owned by parties other than the lessee (CDM 647.5C). RVSD determined that because SWEPI "owns a major interest of the Cortez Pipeline Company through its subsidiary, Shell Cortez Pipeline Company * * * the CDM guidelines under 'producer-owned and operated pipelines,' 647.5A, are most applicable in this case" (Memorandum dated May 6, 1985, at 3). These guidelines provide as follows:

> Intangible and direct costs in the following or like categories which can be shown to the satisfaction of the Supervisor to be part of the operating costs: Insurance (hazard, liability, workman's compensation, etc.); Taxes (Social Security, property taxes assessed on the pipeline and other equipment approved as pipeline investment items, etc. However, corporate income taxes are not an allowable deduction) * * *. [Emphasis added].

RVSD explained that its policy is to deny Federal and state income taxes as transportation costs when the "pipeline is producer-owned and transporting that producer's production only to a sales point" (Memorandum dated May 6, 1985, at 3). By contrast, RVSD noted that "[i]n situations where a third-party pipeline, generally a common carrier, imposes a tariff on a producer under arm's-length conditions, MMS will approve the entire tariff, regardless of how such tariff is derived, as the producer's actual cost of transportation that may be deducted from Federal royalty." Id. Further, "[i]f a pipeline is a common carrier, and carries both affiliated and nonaffiliated production, it is MMS policy to accept a published tariff for the nonaffiliated production, but to require actual cost data to justify an allowance for affiliated production." Id. at 3.

By letter to the Division of Appeals, Office of Program Review, MMS, dated September 9, 1985, SWEPI maintained that other producers not related to the pipeline company would be able to deduct the entire pipeline tariff, whereas it would only be allowed to deduct less than that amount since the portion of the tariff attributable to Federal and income taxes will not be recognized as a transportation cost. SWEPI concluded that this application of the CDM was arbitrary, resulting in "undue discrimination against the producer-owners of the Cortez CO_2 pipeline, a common carrier" (Letter dated Sept. 9, 1985, at 6). SWEPI asserts:

> The producer-owners are subject to liability for a higher royalty payment to the MMS than are other producers of CO_2 from the McElmo Dome (Leadville) Unit or from other CO_2 sources who transport CO_2 through the Cortez CO_2 pipeline, but who do not own an interest in the Cortez CO_2 pipeline, solely because the transportation of CO_2 is not regulated.

Id.

By decision dated August 6, 1986, the Director, MMS, denied SWEPI's appeal, and affirmed the order of the RSVD, explaining its policy of denying the deduction of Federal and state income taxes as transportation costs on the following basis:

> This policy is premised on the impossibility of accurately allocating the correct tax burden to the pipeline, as well as the other activities of the pipeline/producer. An inflated pipeline tariff in those circumstances would benefit the lessee in providing for a greater reduction from royalty (and thereby depriving the lessor of its full royalty entitlement). The MMS adopted the policy of limiting the transportation allowance to actual costs exclusive of income tax. The MMS policy is a reasonable measure intended to eliminate the potential for abuse that could result from expense manipulation between pipelines and production facilities not wholly independent of each other.

(Decision dated Aug. 6, 1986, at 6).

[1] As noted by appellant, MMS relied upon Matzen to support its decision to deny a deduction for incomes taxes as transportation costs. However, the record demonstrates that despite its application of Matzen against SWEPI, MMS does not follow Matzen as a general rule. MMS appears untroubled by the general concept of allowing a lessee to include income taxes paid by a pipeline as an element of transportation costs, since it allows such a deduction if there is a published tariff for a common carrier which includes income taxes as transportation costs. 3/ When there is no published tariff, as in the instant case, only lessees who are affiliates of pipeline owners are not allowed to deduct income taxes as transportation costs from the value upon which royalty is calculated. MMS' application of the Matzen rule only when the lessee is an affiliate of the pipeline owner is untenable.

In Getty Oil Co., 51 IBLA 47 (1980), the Director, Geological Survey (GS), affirmed an order of the Acting Oil and Gas Supervisor, Gulf of Mexico Area, GS, requiring Getty to pay additional royalties for gas sold to its "wholly controlled" subsidiary in accordance with a contract between Getty and the subsidiary. GS contended that since Getty had the right to rescind the contract, and thus sell the gas at higher interstate prices, the Area Supervisor should properly value the gas for royalty purposes as if Getty had sold it at the highest price obtainable on the interstate market.

The Board stated that "[e]ssential to Getty's appeal is the validity of its agreement for the sale of gas to [its subsidiary]." 51 IBLA at 49. The Board's analysis of this issue is relevant to the issue of whether MMS should have denied SWEPI the income tax deduction on the basis that it wanted to "eliminate the potential for abuse that could result from expense

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3/ The Board has held that section 28 of the Mineral Leasing Act of 1920, as amended, 30 U.S.C. § 185 (1982), provides the authoirity for issuance of a right-of-way for a carbon dioxide pipeline for transportation of produc- tion from Federal oil and gas leases. Exxon Corp., 97 IBLA 45, 94 I.D. 139 (1987). Such pipelines are required by statute to be operated as "common carriers." 30 U.S.C. § 185(r)(1) (1982).

manipulation between pipelines and production facilities not wholly independent of each other" (Decision by Director, MMS, dated Aug. 6, 1986, at 6). The Board stated:

> We agree with appellant that a parent corporation and its wholly owned subsidiary may enter into a valid contract. In United States v. Weissman, 219 F.2d 837 (2nd Cir. 1955), Judge Learned Hand wrote: "It is true that there can be legal transactions between two corporations all of whose shares are owned by a single individual, and that the same obligations will arise out
> of them as would arise, had they been between either corporation and a third person." It is the general rule that courts will not, because of stock ownership or interlocking directorates, disregard the separate legal identities of corporations, unless such relationship is used to defeat public convenience, justify wrongs (e.g., violation of antitrust laws), protect fraud, or defend crime. Norton v. Integral Corp., 584 S.W.2d 932, 935 (1979).

51 IBLA at 50.

MMS proceeds on the assumption that when the lessee is an affiliate of the pipeline operator, the income tax burden of the operator may somehow be shifted to the lessee, thereby reducing the amount upon which Federal royalty on the CO_2 is calculated. MMS' policy, while "intended to preclude abuse and overcome audit burdens," unfairly discriminates against lessees who are affiliates of pipeline operators. In the absence of some manifestation that affiliated companies are using their corporate relationship to defeat MMS royalty collection efforts, the general rule recognized in Getty Oil Co. applies. 4/ MMS does not allege, and there is nothing in the record to suggest, that Cortez is not transporting SWEPI's CO_2 at a price equal to that obtainable under an arms-length contract. MMS' denial of a transportation allowance for income taxes in this case solely on the basis that SWEPI is an affiliate of the pipeline operator was improper.

4/ Moreover, the factual predicates of the MMS decision are substantially undermined by the fact that SWEPI owns only a 50-percent interest in the Cortez pipeline. While the Board has, indeed, recognized that economic incentives exist which might impel producers to shift profits to wholly owned subsidiaries as a means of decreasing royalty obligations (see Transco Exploration Co., 110 IBLA 282, 96 I.D. 367 (1989)), the economic viability of such a strategy declines where, as here, outside interests in the subsidiary are substantial. Thus, while a parent corporation might well desire to have profits transferred form one corporationn to another in an attempt to lessen royalty payments of 12.5 percent on the value of production, the incentive to do so when the parent corporation owns only 50 percent of the second corporation evaporates, since such a procedure results in the net loss of 37.5 percent. Similarly, it is difficult to see how the manipulation of allocation of income taxes works effectively where the parent corporation owns only 50 percent of one of the entities involved, particularly where the expressed fears of MMS can only be real-ized by increasing the tax burden of the partially-owned entity.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, is set aside and remanded for action consistent with this opinion.

Gail M. Frazier
Administrative Judge

I concur:

James L. Burski
Administrative Judge